

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Kelley Analyst: Marion Mann DeJong Bill Number: AB 45X
Related Bills: See Legislative History Telephone: 845-6979 Introduced Date: 02/09/2001
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Manufacturers' Investment Credit/Extends to Major Group of Other Electric Power Generation

SUMMARY

This bill would extend the Manufacturers' Investment Credit (MIC) to certain electric power generation corporations.

PURPOSE OF THE BILL

The purpose of this bill appears to be to encourage investment in property that generates electricity by alternative energy sources (e.g., solar, wind, geothermal, solid-fuel biomass, waste tire, municipal solid waste, digester gas, or hydropower).

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2001.

POSITION

Pending.

Summary of Suggested Amendments

At the request of the author's staff, department staff is drafting amendments to remove the employee wage and health benefit provisions. Amendments are also being drafted to resolve binding contract dates and definitional problems. See "Implementation Considerations" below. The amendments are not in this analysis, instead they will be provided to the author separately.

ANALYSIS

FEDERAL/STATE LAW

Existing state and federal laws allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer's trade or business and allow a depreciation deduction for the obsolescence or wear and tear of property used in a trade business or held for the production of income.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
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<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Gerald H. Goldberg

3/9/01

Existing federal law does not have a credit comparable to the MIC. However, federal law does provide an investment property credit for certain depreciable or amortizable property that qualifies for the rehabilitation, energy, or reforestation credit. The energy credit is 10% of the basis of each energy property placed in service during the tax year. "Energy property" is:

- Equipment that uses solar energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat; or
- Equipment used to produce, distribute, or otherwise utilize energy from a geothermal deposit. In the case of electricity generated by geothermal power, only equipment used up to but not including the electrical transmission stage is "energy property."

Existing federal law also provides a renewable electricity production credit. For 2000, the credit is 1.5 cents per kilowatt hour of electricity produced at a "qualifying facility" by taxpayers from wind, "closed-loop biomass," (generally, organic plants, except timber, grown for the sole purpose of being used to generate electricity), or poultry waste. The electricity must be sold to an unrelated person during the taxable year. The credit is available for a ten-year period beginning the year the facility is placed in service.

Existing state law allows qualified taxpayers a credit, known as the MIC, equal to 6% of the amount paid or incurred after January 1, 1994, for qualified property that is placed in service in California.

For purposes of the MIC, a qualified taxpayer is any taxpayer engaged in manufacturing activities described in specified codes listed in the Standard Industrial Classification (SIC) Manual, 1987 edition. Qualified property is any of the following:

1) Tangible personal property that is defined in Section 1245(a) of the Internal Revenue Code (IRC) and used primarily:

- for manufacturing, processing, refining, fabricating, or recycling of property;
- for research and development;
- for the maintenance, repair, measurement, or testing of otherwise qualified property; or
- for pollution control that meets or exceeds state or local standards.

2) The value of any capitalized labor costs directly allocable to the construction or modification of the property listed in #1 above or for special purpose buildings and foundations listed in #3 below.

3) For certain taxpayers engaged in specified SIC Code activities, special purpose buildings and foundations.

For taxpayers engaged in computer programming and computer software related activities, qualified property includes computers and computer peripheral equipment used primarily for the development and manufacture of prepackaged software, and the value of any capitalized labor costs directly allocable to such property.

The MIC explicitly excludes certain types of property from the definition of qualified property, such as furniture, inventory, and equipment used in an extraction process.

THIS BILL

Under the Bank and Corporation Tax Law (B&CTL), this bill would extend the MIC to taxpayers engaged in businesses relating to “other” electric power generation.

Businesses that meet the following requirements would be added to the definition of “qualified taxpayer” for purposes of the MIC:

- Engaged in businesses relating to “other” electric power generation as described in the North American Industry Classification System (NAICS) Manual Code 221119, 1997 edition, as follows:

“Establishments primarily engaged in operating electric power generation facilities (except hydroelectric, fossil fuel, and nuclear). These facilities convert other forms of energy, such as solar, wind, or tidal power, into electrical energy. The electric energy produced in these establishments is provided to electric power transmission systems or to electric power distribution systems.”
- Certify in writing to the Franchise Tax Board that they pay their employees a living wage and provide health insurance.
- Do not produce electricity for sale to a utility pursuant to a contract originally entered into before January 1, 2001.

The definition of qualified property would be modified to include property used in businesses relating to “other” electric power generation (NAICS Code 221119).

The definition of “manufacturing” would be modified to include the production of electricity from one or more of the following energy sources: solar, wind, geothermal, solid-fuel biomass, waste tire, municipal solid waste, digester gas, or hydropower with a generating capacity of 30 megawatts or less.

The binding contract rules in the MIC would be modified so that purchases of equipment pursuant to a binding contract entered into before January 1, 1998, by taxpayers engaged in “other” electric power generation would not qualify for the credit. The bill would also change the dates in the binding contract rules for certain leases of qualified property.

This bill would require the credit to be recaptured if the qualified taxpayer engaged in “other” electric power generation did not pay their employees a living wage and provide health insurance.

IMPLEMENTATION CONSIDERATIONS

The department has identified the implementation concerns listed below. Department staff is working with the author’s office to resolve these matters.

- This bill does not make a corresponding change to the MIC under the Personal Income Tax Law (PITL) Section 17053.49, which may cause taxpayer confusion. Taxpayers that are shareholders of an S corporation may be especially confused since a B&CTL credit cannot flow from the S corporation to the shareholder.

Similarly, partnerships and their partners would be ineligible for this credit since the partnership provisions are contained in the PITL. This could lead to disputes between taxpayers and the department. The author's staff has requested amendments to make corresponding changes to the PITL.

- The provisions relating to employee wages and health insurance are internally inconsistent. Under the definition of qualified taxpayer, "other" electric power producing taxpayers are required to certify that it pays its *employees* a living wage and provides health insurance. However, the bill then specifies that to receive a credit on or after January 1, 2001, a qualified taxpayer must provide health insurance and specified wages to *all employees employed within a targeted tax area*. Thus, it is unclear whether the wage and benefits must be provided to all employees or just employees employed within a targeted tax area. Further, the bill does not define "targeted tax area," "living wage," or "employer-sponsored health insurance." Unclear terms can cause disputes between taxpayers and the department. The author's staff has requested amendments to remove the provisions relating to employee wages and health insurance.
- The bill requires the recapture of the credit if the employee wage and health insurance requirements are not met. The recapture would be required in the first year beginning after the operative date of the bill. This would cause implementation problems when the statute of limitation closes on that year. The author's staff has requested amendments to remove the provisions relating to employee wages and health insurance, which would eliminate this consideration.
- The binding contract language in the bill is internally inconsistent. The bill amended the normal binding contract provisions of the MIC to specify that binding contracts entered into on or after January 1, 1998, would qualify for the credit. However, the bill also adds binding contract language in the definition of "qualified taxpayer" that specifies that contracts entered into before January 1, 2001, would not qualify for the credit. The author's staff requested amendments to make both dates January 1, 2001.
- This bill adds taxpayers engaged in business described in NAICS Manual Code 221119 to the MIC. NAICS Manual Code 221119 defines these businesses as "establishments primarily engaged in operating electric power generation facilities (except hydroelectric, fossil fuel, and nuclear)." However, the changes made in the definition of manufacturing include the production of electricity by "hydropower." This appears to be in conflict with the definition in the NAICS Code 221119. The sponsor of the bill is working to resolve this concern.
- This bill modifies the definition of manufacturing to include electric power generation. It is preferable to add a new qualifying activity definition tailored for the electric power generation taxpayer. The author's staff requested amendments to add a new qualifying activity.

TECHNICAL CONSIDERATIONS

Since taxpayers engaged in electric power generation do not develop or manufacture software, it is unnecessary to include their NAICS code in the description of property used to develop or manufacture software. This issue will be resolved in the amendments provided to the author separate from this analysis.

LEGISLATIVE HISTORY

SB 1920, Kelley (1999/2000) was identical to this bill. SB 1920 was held in the Senate Revenue and Taxation Committee.

AB 2461, Runner (1999/2000) would have increased the MIC from 6% to 8% and extended the MIC to taxpayers engaged in extracting nonmetallic minerals and the generation of electricity. AB 2461 was held in the Assembly Revenue and Taxation Committee.

AB 2596, Corbett (1999/2000) would have extended the MIC to taxpayers engaged in the generation of electricity using natural gas. AB 2596 was held in the Assembly Appropriations Committee.

AB 240, Runner (2001) would increase the MIC to 7%, extend the credit to taxpayers engaged in mineral extraction or electric power generation, and delete the repeal date.

AB 278, Cohn (2001) would increase the MIC to 7% and extend the repeal date to 2008.

OTHER STATES' INFORMATION

Review of *Illinois*, *Massachusetts*, *Michigan*, and *New York* tax laws found no comparable tax credit for investments in property used to generate electricity like that proposed by this bill. The laws of these states were reviewed because they have credits comparable to the MIC.

FISCAL IMPACT

If the implementation considerations addressed in this analysis are resolved, the department's costs are expected to be minor.

ECONOMIC IMPACT

Revenue Estimate:

Based on the discussion below, the revenue loss from this bill is as follows:

Revenue Impact of ABX45 For Taxable/Income Years Beginning 1/1/2001 Assumed Enactment After 6/30/2001 Fiscal Years (In Millions)		
<u>2001-2</u>	<u>2002-3</u>	<u>2003-4</u>
-\$5	-\$9	-\$10

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this proposal.

Tax Revenue Discussion:

The revenue impact of this credit would depend on the amount of qualified costs incurred and the tax liability of qualified taxpayers. This estimate includes losses under the PITL since the author's staff has indicated that the bill will be amended to include PIT taxpayers.

Qualified costs were estimated from an U.S. Census Bureau survey of capital expenditures by industries in SIC codes 4911, 4931 and 4939 for 1997. Qualified costs were then factored down to reflect NAICS Code 221119, which is an industry subgroup of the above SIC codes. The 1997 numbers were grown to approximate year 2001 and beyond. Adjustments were made for pre-existing contracts entered into before January 1, 2001 for the production of electricity for sale to a utility and for employee health insurance coverage.

Based on key findings from the 1999 California Employer Survey it is estimated that approximately 85% of the taxpayers in the major group of other electric power generation, NAICS Code 221119, would offer health insurance coverage to employees. Of these taxpayers it was assumed that approximately 50% in the first year would have existing contracts entered into before January 1, 2001.

The credit use rates taken from the microsimulation model of California tax returns were then applied to derive the aggregate credit use. The fiscal year cash flow patterns are based on FTB analysis of how manufacturers adjusted their tax payments to reflect the reduction in liability resulting from the current law MIC.

This estimate does not include losses resulting from qualified taxpayers as defined under current law that might receive additional credit for activities that would qualify under the definition of manufacturing provided by this bill. Such losses cannot be quantified since the taxpayers engaged in the production of electricity, but whose primary business is manufacturing, cannot be identified.

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ARGUMENTS/POLICY CONCERNS

This bill would expand the definition of manufacturing to include the production of electricity from specified energy sources. As a result, taxpayers that qualify for the MIC under existing law could claim the MIC for existing auxiliary activities that satisfy this expanded definition of manufacturing. The author's staff has asked the department to draft amendments to maintain the current definition of manufacturing and place the electric activity in the definition of qualified property for taxpayers engaged in activities classified under NAICS Code 221119.

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